

CIA/OER EIWA 74/09/14 WEST GERMANY: COSTLY BATTLE
C/NFD MAR 1974 01 OF 01

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Annex to

Economic Intelligence Weekly

*West Germany: A Costly Battle
Against Inflation*

Confidential
CIA No. 7930/74/A
14 March 1974

Copy No 204

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§ 5B(1), (2), and (3)
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WEST GERMANY: A COSTLY BATTLE AGAINST INFLATION

1. Bonn remains strongly committed to fighting inflation, even at a substantial cost in economic growth. The official forecast for 1974, which seems reasonable, is for an increase in real GNP of only 0%-2%, compared with 5.3% last year. West Germany will have one of the lowest growth rates among major developed countries.

2. Bonn's fiscal policy will not be as restrictive this year as it was during much of 1973; at the same time, monetary policy is likely to remain very tight. A firm rein on domestic demand enabled West Germany to hold inflation in 1973 below rates in other major countries. Because of this curb on demand, real output failed to rise after a promising first quarter. Restrictions on the growth of domestic demand remained much more important than energy supply problems in preventing growth in GNP, even in the fourth quarter.

3. Whether economic growth this year is at the low or high end of the 0%-2% range will depend on Bonn's response to slack demand. The worldwide economic downturn will cut into foreign demand for German goods. Moreover, domestic purchasing power will be reduced in real terms as the \$6.0 billion hike in the oil import bill raises prices throughout the economy. The inflation rate is likely to jump to about 10% from last year's 7%. Unemployment—already at its highest level since 1967—probably will double last year's average of 1.2%. Economic conditions clearly will raise new problems for the already troubled government coalition of Social Democrats and Free Democrats.

Recent Developments

4. The economy's resurgence in late 1972 and early 1973, following the shallow contraction of 1970-71, was short-lived. With credit being limited in order to slow inflation, weakening demand checked growth after a first-quarter spurt. Tightened monetary controls and restrictive fiscal measures implemented in mid-year continued to inhibit growth. The money supply declined during the last three quarters, following a rapid rise in the first quarter; for the year as a whole the increase was held to an average of 5.7%. The gain in real GNP for the whole year nonetheless reached 5.3%—somewhat above the long-term average.

5. The adverse impact of tight credit on output showed up most quickly and strongly in construction—particularly residential construction. Industrial production ended the year about 5% above its December 1972 level despite falling output of consumer goods. Export orders permitted substantial production increases in basic materials and investment goods industries even though domestic demand was slack. Because of its ability to bid oil away from competitors, West German industry experienced few output constraints traceable to oil shortages. Production cutbacks announced in late 1973

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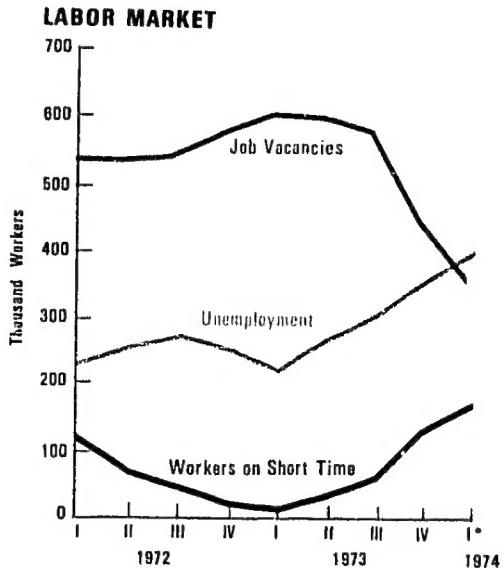
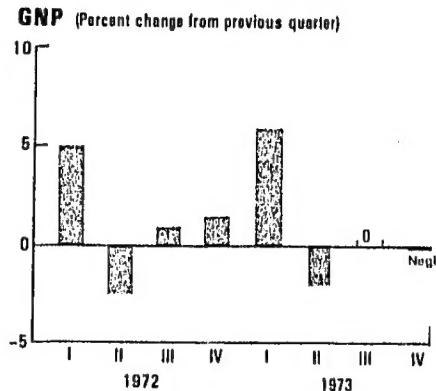
resulted partly from the climate of pessimism and uncertainty. Reduced construction activity and industrial growth caused a rapid climb in unemployment and short-time work after the first quarter and a sharp drop in job vacancies later.

6. Although the boom in real output was truncated, inflation continued to accelerate. The round of labor negotiations a year ago caused unit-wage costs to rise to their highest level in two decades. Import prices for foodstuffs and raw materials climbed steeply in late 1972 and early 1973. Late last year, higher oil costs added to these price woes. Consequently, rises in producer prices for domestic and export sales, as well as in the cost-of-living index, accelerated during 1973.

7. Foreign demand for West German products remained so strong that the 1973 trade surplus reached a record \$16 billion (imports on an f.o.b. basis). As the worldwide boom began to strain productive capacity in most industrial countries, buyers turned increasingly to German firms.

Weakening domestic demand put German producers in a position to promptly deliver most types of goods. Moreover, their prices remained favorable in spite of the mark's rising value. West German prices were rising less rapidly than foreign prices, and German firms trimmed profit margins to maintain competitiveness. These factors, together with traditional preferences for West German quality and technology, swamped the negative influence on exports of the mark's trade-weighted appreciation of 13% during the first half of the year.

WEST GERMANY: THE BOOM THAT WASN'T



*Estimate based on January-February data.

Note: Data are seasonally adjusted.

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As a result, West German exports jumped by 19% in volume and 20% in terms of dollars—nearly twice the average rates in 1970-72. With a rise in the value of imports of 13%, substantially larger deficits on services and transfers, and a sizable net outflow of capital, West Germany finished the year with a \$6 billion balance-of-payments surplus.

8. Worried about provoking a recession in the spring of 1974, Bonn eased fiscal policy in the last quarter of 1973. In December it dropped nearly all of the anti-inflationary fiscal measures adopted in mid-1973 and authorized construction of 50,000 additional public housing units. More recently, the federal and state governments decided to undertake additional capital expenditures to help certain industries and regions. Although banks' minimum reserve requirements were cut back in January to compensate for dollar outflows, monetary policy remains tight.

Prospects for 1974

9. The West German economy faces its poorest year since 1967. Bonn foresees only a 0%-2% growth of real CNP, continuing rapid inflation, and sharply higher unemployment. With industry running well below capacity, tight oil supplies will have little effect on output. But the extra \$6 billion to be paid for oil imports this year will adversely affect the growth of industrial production. One bright spot in the picture: a substantial trade surplus is anticipated despite the large increase in oil import costs.

10. For the present, Bonn is adhering to its policy of using monetary restraints to fight inflation and selective fiscal measures to deal with unemployment. Both the government and the Bundesbank feel that planned public spending will have an expansionary effect in 1974. The government will wait for clearer indications of changes in personal and business spending plans before shifting its policies.

Higher Prices, Fewer Jobs

11. The spiraling cost of living has led to new militancy among organized workers and brought demands for large wage increases. Bonn estimates that, if wage settlements continue to breach the government's 10% guideline, consumer prices will rise by at least 10% and unemployment will reach 2.5%-3%. Several key negotiations involving the public service employees and the metalworkers recently resulted in combined wage and fringe-benefit hikes of 12%-14%. Increased oil prices alone will account for 2-2-1/2 percentage points of the anticipated rise in consumer prices.

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The Foreign Sector: Less Helpful Than Usual

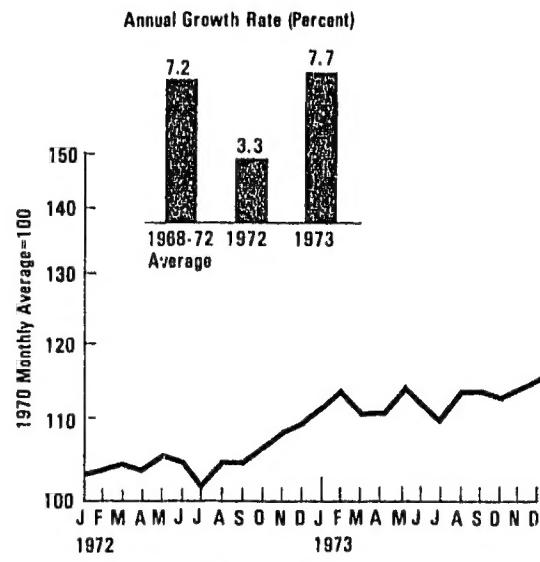
12. Official projections indicate a \$6 billion drop in the trade surplus this year, to \$10 billion. In spite of the economy's stagnation, imports are expected to increase by at least the \$6 billion boost in the oil import bill. Exports probably will change little. The current account is expected to slip from a \$3.5 billion surplus in 1973 to near balance in 1974, even though foreign workers' remittances and net tourist expenditures by the Germans will fall off. Because of a continued net outflow of both long-term and short-term capital, primarily to the United States, the balance of payments probably will end up several billion dollars in the red.

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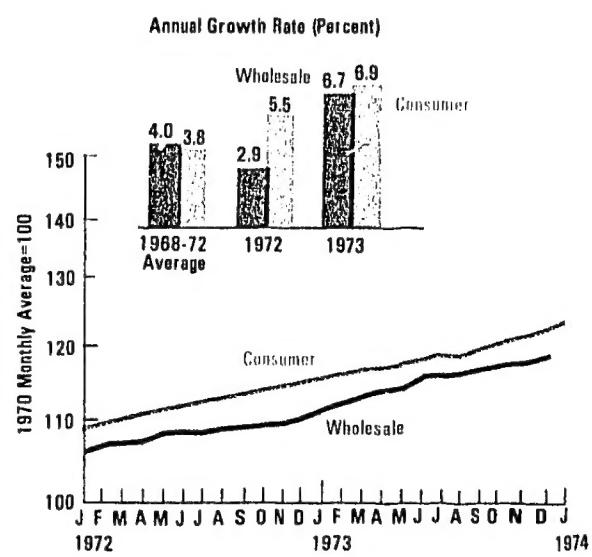
WEST GERMANY: INTERNAL ECONOMIC INDICATORS

INDUSTRIAL PRODUCTION*

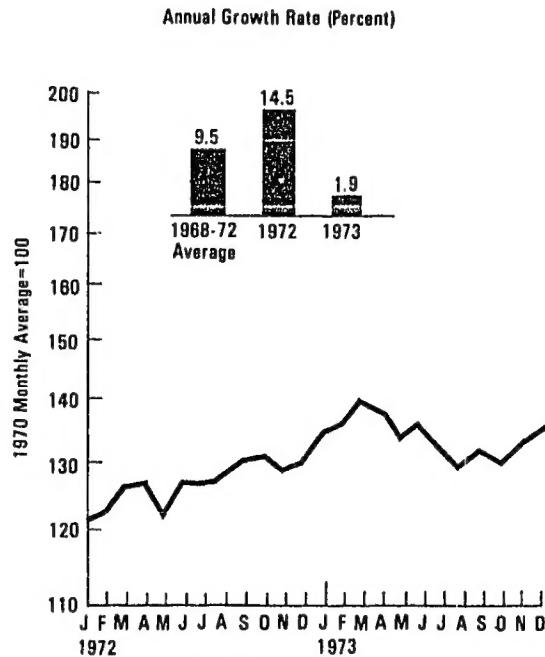


*Seasonally adjusted

PRICES



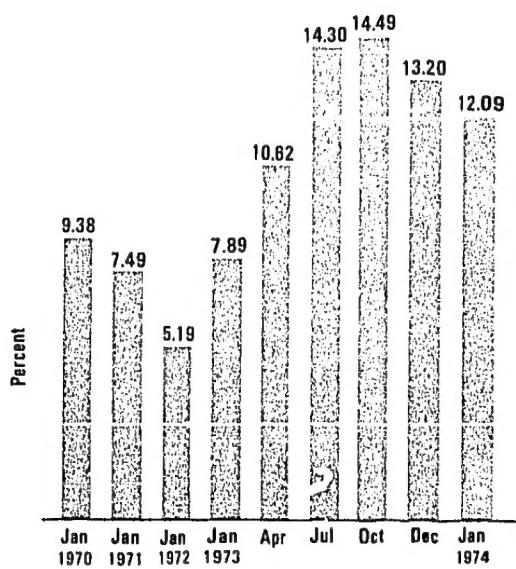
MONEY SUPPLY*



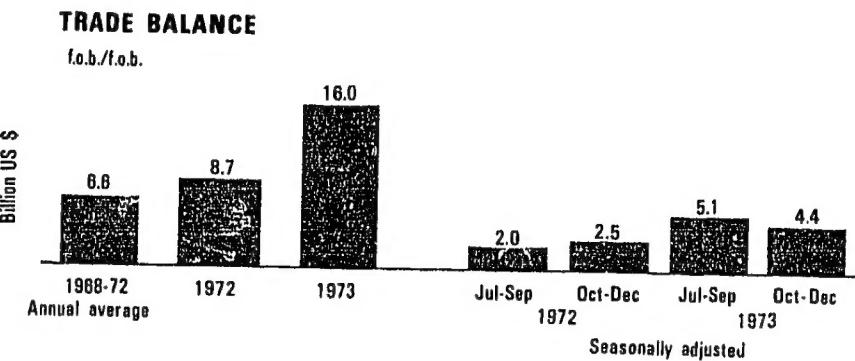
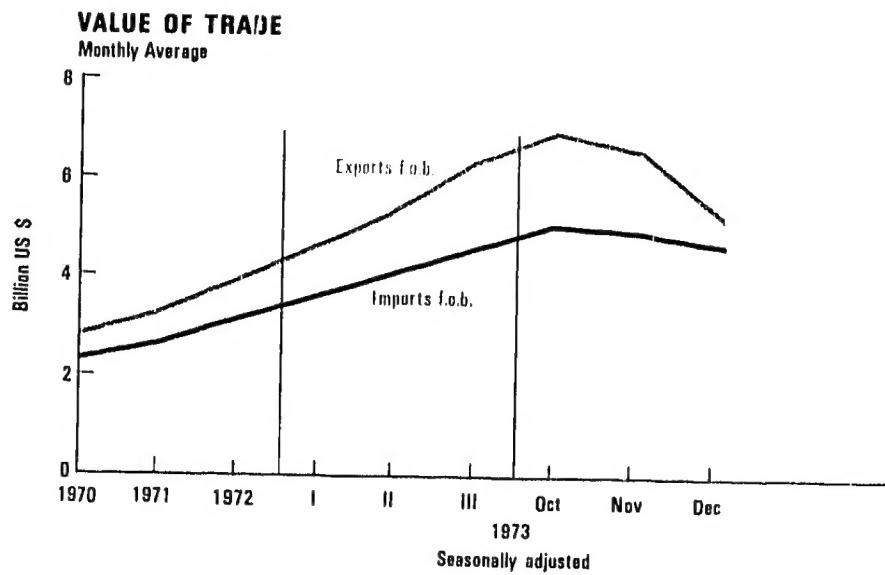
*Seasonally adjusted. End of period.

MONEY MARKET RATES

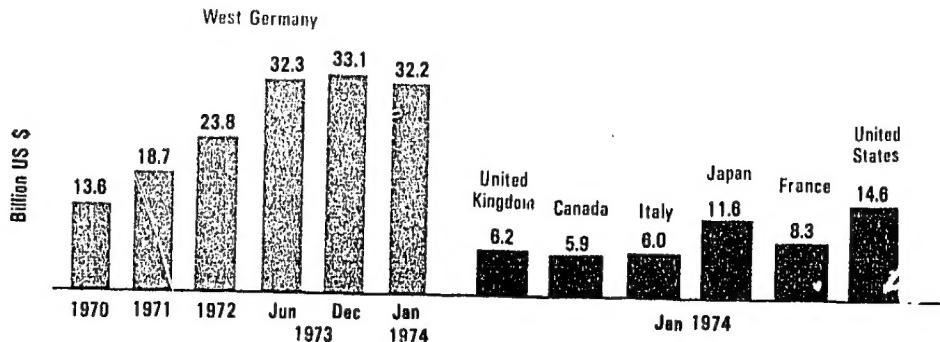
Interest Rate for Interbank Loans (3 months)



WEST GERMANY: EXTERNAL ECONOMIC INDICATORS



OFFICIAL RESERVES

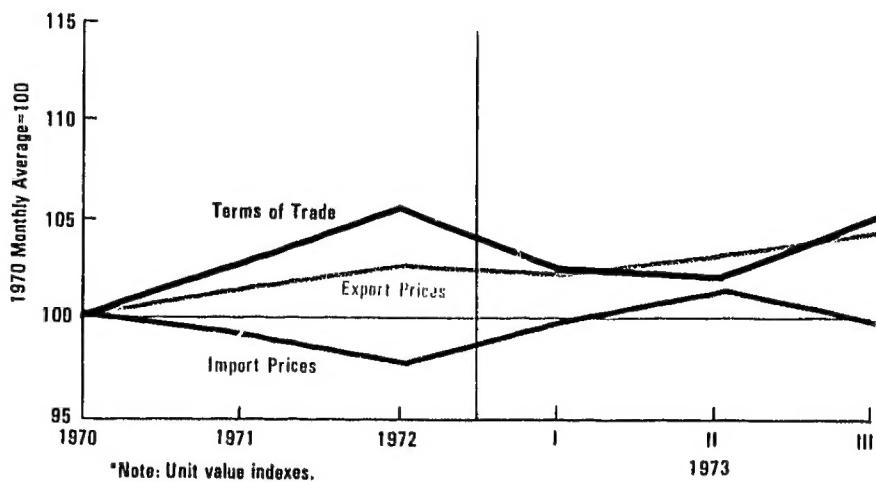


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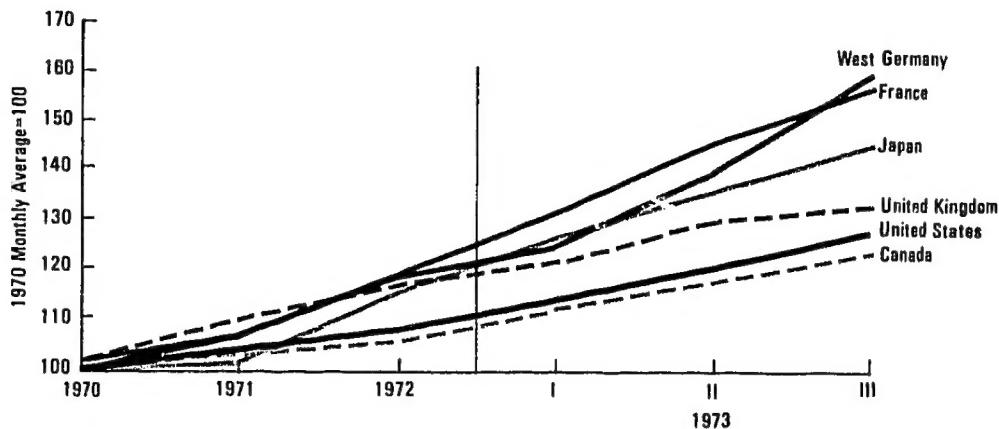
WEST GERMANY: EXTERNAL ECONOMIC INDICATORS

TERMS OF TRADE

National Currency*

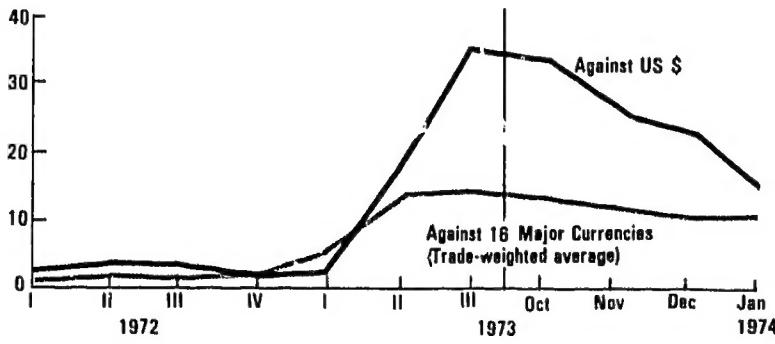


EXPORT PRICES IN US \$



EXCHANGE RATES FOR THE WEST GERMAN MARK

Percent Change from 18 Dec 71



Note: End of period.